

# **G. SELF-DEALING AND OTHER TAX ISSUES INVOLVING CHARITABLE REMAINDER UNITRUSTS**

by  
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## **1. Introduction**

A trust as a means for charitable giving has always been popular with philanthropically inclined individuals. To eliminate abuses in existing trusts with both charitable and noncharitable beneficiaries, Congress enacted IRC 664. This provision permits an individual to make a deferred gift through a charitable remainder unitrust to a charity that eventually acquires ownership or use of that gift. In turn, that individual is conferred certain tax benefits: a federal income tax deduction for donating this deferred gift and annual payments from the charitable remainder unitrust for a period of time.

Some charitable remainder unitrusts are now being used for an improper purpose -- to transform highly appreciated assets into cash while shielding a substantial portion of the gain from tax. In Notice 94-78, 1994-32 I.R.B. 15, the Service announced its intention to deter such exploitation and abuse of charitable remainder unitrusts by imposing IRC 4941 taxes on the appropriate persons involved in this scheme. The Service also may tax this gain. Such taxation will be based upon several legal doctrines.

The purpose of this article is to educate exempt organizations examiners about this scheme, aide them in identifying and examining unitrusts that are used in this scheme, and inform them of the remedies that are available to annul the outcome of this scheme. This article will discuss the following: 1) what charitable remainder unitrusts are, 2) how they are being exploited, 3) the key elements in the scheme, and 4) the use of IRC 4941 to rectify this abuse. This article will also highlight the legal doctrines that could be used to tax the gain.

## **2. Background - Unitrusts**

### **A. Classes of Trusts - Split Interest Trust and Tax-Exempt Charitable Trusts**

Unitrusts are charitable remainder trusts, which are a sub-class of a class of non-exempt trusts known as "split-interest" trusts. The other class of trusts is the

non-tax-exempt charitable trust. Non-exempt charitable trusts provide income only to charitable beneficiaries. Both non-exempt charitable trusts and split interest trusts are subject to tax to the extent provided for in Subchapter J. Unitrusts are exempt from tax, not because they are described in IRC 501(a), as are most tax-exempt organizations, but because IRC 664(c) provides for such treatment. See generally 1983 CPE (A General Explanation of Trusts Subject to IRC 4947), at 173-175.

Non-exempt charitable trusts provide payments only to charitable beneficiaries. Split interest trusts provide payments to non-charitable beneficiaries and charitable beneficiaries. See generally 1983 CPE, supra, at 173-187.

#### B. Charitable Remainder Trusts - Unitrusts

Unitrusts are one of two types of charitable remainder trusts described in IRC 664. In unitrust, the donor provides the assets, as the trust corpus, to the unitrust. The trustee, whose appointment is provided for in the trust instrument, administers the unitrust, and is required to make payments from the unitrust to one or more non-charitable beneficiaries for their life or a fixed period of years. The amount of the payments is determined by the percentage of the net fair market value of the unitrust's assets, as valued annually. The percentage must be a fixed number and cannot be lower than 5 percent. When the non-charitable beneficiaries pass away or the fixed period of years ends, the assets in the unitrust are paid over to or are held for the benefit of a charitable organization or organizations described in IRC 170(c). The following example illustrates a typical unitrust:

**Example:** The 60 year-old creator of a unitrust donates \$500,000 cash, as trust corpus, to that unitrust on January 1, 19X1. The trust instrument provides that 1) the sole income beneficiary is the creator, 2) the unitrust will pay 5 percent of the net fair market value of the unitrust assets as valued annually, 3) the unitrust must make an annual payment to the income beneficiary for 15 years, and 4) the remainder beneficiary is an IRC 501(c)(3) organization. The creator receives a federal income tax deduction for the charitable contribution. On December 30, 19X1, the unitrust asset is \$540,000 of Treasury bonds and the trustee distributes \$27,000 from the unitrust to the creator. At the end of the 15th year, the trustee makes the final payment to the contributor, dissolves the unitrust, and transferred the corpus to the IRC 501(c)(3) organization.

The other type of charitable remainder trust is the annuity trust. Annuity trusts are very similar to unitrusts, for they also make payments to one or more non-charitable beneficiaries.

The major difference is the method of determining payments. The annuity trust payment is a set dollar amount (which is at least 5 percent of the net fair market value of the trust assets valued as of the date of transfer, see IRC 664(d)(1)(A)) whereas the unitrust payment, as mentioned, is a fixed percentage of the fair market value of trust assets valued annually.

### C. Unitrusts - Basis for Exemption

IRC 664(c), as indicated above, provides that unitrusts (and annuity trusts) are generally exempt from all taxes imposed by Subtitle A, Chapter 1, of the Internal Revenue Code. Those taxes include, among others, the federal income tax. IRC 664(c) also provides that the tax exemption of a unitrust is lost for any taxable year in which the unitrust has unrelated business income tax. The definition of unrelated business income tax is determined by section 512(a), which is also applicable to organizations recognized as exempt under section 501(a) of the Code.

### D. Tax Deduction

The donor of the unitrust's assets is entitled to an income tax deduction for the charitable contribution. See IRC 170(a), (c), (f)(2)(a)<J12>. The income tax deduction for the charitable contribution is the present value of the remainder interest the charitable beneficiaries will receive at the expiration of these non-charitable beneficiaries' interest. The procedures to calculate the present value of the remainder interest -- hence, the amount of the income tax deduction -- are outlined in Regs. 1.664-4(b)(3), (4).

## 3. Unitrusts, IRC 4941, and Other Private Foundation Provisions

IRC 4947(a)(2) was added to the Code by the Tax Reform Act of 1969. Under IRC 4947(a)(2)(C), chapter 42 of the Code does not apply to amounts transferred in trust prior to May 27, 1969. Unitrusts are all subject to many of the chapter 42 provisions because they meet the requirements of 4947(a)(2), i.e. they are not exempt from tax under IRC 501(a), not all of their unexpired interests (i.e. the non-charitable income interests) are devoted to charitable purposes, they have amounts in trust for which a deduction was allowed under IRC 170, IRC 2055, or

IRC 2522, and because IRC 664 is effective for years beginning on or after Jan. 1, 1970. See IRC 4947(a)(2).

Specifically, many unitrusts are subject to the following private foundation provisions: IRC 4941 (taxes on self-dealing); IRC 4943 (taxes on excess business holdings); IRC 4944 (relating to investments which jeopardize charitable purpose); IRC 4945 (taxes on taxable expenditures); IRC 507 (relating to termination of private foundation status); and IRC 508(e) (relating to the governing instrument of the foundation). IRC 4943 and IRC 4944 do not apply to a split-interest trust if that trust meets either of two conditions: 1) all of the income interests (and none of the remainder interests) of the trust are devoted solely to charitable purposes and all amounts in trust for which a charitable deduction was allowed have an aggregate value of not more than 60 percent of the aggregate fair market value of all amounts in trust, or 2) a charitable deduction was allowed for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary. See IRC 4947(b)(3)(A) & (B). For a detailed discussion of IRC 4943 and IRC 4945, see the 1995 CPE (Private Foundations in the Mid-1990s with an Emphasis on IRC 4941 and IRC 4945), at pp. 247-316. This article focuses on IRC 4941, for the other provisions are not relevant to the topic of this article.

#### A. IRC 4941 - Elements

IRC 4941 levies a series of excise taxes on any direct or indirect act of self-dealing between a private foundation and disqualified person. For IRC 4941 to apply, there must be a private foundation, a disqualified person, and a self-dealing transaction between them. See 1995 CPE, supra, at pp. 248-291; see also 1990 CPE (Recent Development), at pp. 253-291; 1985 CPE (The Nature of Self-Dealing), at pp. 235-264.

##### (1) Treatment of Unitrusts as if Private Foundations

For certain purposes, unitrusts are treated as if they were private foundations. These include IRC 4941.

##### (2) Donor and Trustee as Disqualified Persons

The donor and trustee of a unitrust are disqualified persons. Disqualified persons are defined in IRC 4946(a)(1), which is applicable to unitrusts by virtue of the fact that IRC 4941 applies to them. The term includes a person who is, with

respect to a private foundation -

- (A) a substantial contributor to the foundation;
- (B) a foundation manager;
- (D) a member of the family of any individual described in (A) or (B);

The donor of a unitrust is a substantial contributor by definition. IRC 507(d)(2)(A) (applicable to unitrusts) provides that a substantial contributor includes a person who 1) contributes or bequeaths more than \$5,000 to a private foundation and 2) the aggregate amount of the person's gifts and bequests amounts to more than two percent of the total contributions and bequests for all years received by the foundation before the close of the foundation's tax year. This provision also states that in a case of a trust, the creator of the trust is also a substantial contributor.

A trustee of a unitrust is a foundation manager by definition. Reg. 53.4946-1(f)(2) provides that the definition of a foundation manager includes a trustee, officer, or director of a foundation or any person having powers or responsibilities similar to that of a trustee, officer, or director. For example, a person is an officer of a foundation if he or she is specifically so designated under the trust instrument or document, bylaws, certificate of incorporation or other constitutive documents. A person is also an officer of a foundation if he or she regularly exercises general authority to make administrative or policy decisions on behalf of the foundation. Independent contractors such as attorneys, accountants, and investment managers and advisors acting in such capacity are not officers. Note that a donor may also serve as the trustee of the unitrust. See section 4 infra. In this situation, that donor is a disqualified person under either or both definitions.

### (3) Direct and Indirect Acts of Self-Dealing

A direct act of self-dealing occurs where the income or assets of a unitrust, a private foundation for this purpose, are transferred to, or for the use by or benefit of, a disqualified person. See Reg. 53.4941(d)-2(f)(1). An indirect act of self-dealing is also prohibited. Indirect self-dealing includes any transaction between the disqualified person and an organization controlled by a private foundation. See Reg. 53.4941(d)-1(b)(1); 1995 CPE, supra, at 279-287 (discussing

indirect acts of self-dealing, and providing examples illustrating such acts).

Reg. 53.4941(d)-2(f)(2) states that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

#### (4) Self-Dealing Taxes

IRC 4941(a)(1) permits the Service to impose an initial excise tax on each act of self-dealing between a disqualified person and the unitrust. The tax is imposed on that disqualified person, even though he or she had no knowledge at the time of the act that the act constituted self-dealing. Reg. 53.4941(a)-1(a). In the case of a unitrust trustee, a foundation manager by definition, two elements must be shown before taxes may be imposed on him or her: 1) knowledge that the act is an act of self-dealing and 2) his or her participation is willful and not due to reasonable cause.

The initial excise tax imposed is at the rate of 5 percent of the amount involved with respect to the act of self-dealing for each year or partial year in the taxable period. See IRC 4941(a); IRC 4941(e)(2); Reg. 53.4941(e)-1(b). If the self-dealing act is not corrected, IRC 4941(b)(1) provides that a second-tier tax be imposed on the disqualified person. The tax rate of the second-tier tax is 200 percent of the amount involved and is to be paid by that disqualified person.

#### (5) Amount Involved

Regs. 53.4941(e)-1(b)(ii) states,

"Where the use of money or other property is involved, the amount involved [in a self dealing act] shall be the greater of the amount paid for such use or the fair market value for such use for the period for which the money or other property is used. Thus, for example, in the case of a lease of a building by a private foundation to a disqualified person, the amount involved is the greater of the amount of rent received by the private foundation from the disqualified person or the fair rental value of the building for the period such building is used by the disqualified person."

#### 4. Unitrusts - Basic Technical Requirements

In order for a trust to qualify legally as a unitrust under IRC 664(d)(2), the trust must meet certain basic requirements.

- a. Valid Trust Instrument - The trust instrument must be irrevocable and be a legal, valid trust instrument in the state where it was created. Furthermore, the trust instrument must comply with any requirements outlined under IRC 664 and the regulations thereunder.
- b. Trustee - A trustee or trustees must be appointed to oversee the administration of the unitrust. Anyone may serve as trustee of the unitrust provided that that person is acceptable under the terms of the unitrust's governing instrument and is not forbidden by state law. The grantor may also serve as trustee subject to certain limitations. See IRC 671 et seq.
- c. Beneficiaries/Recipients - Annual payments must be made to at least one "person" that is not an organization described in IRC 170(c). See IRC 664(d)(2)(A). The definition of person includes an individual, trust, estate, association, company, corporation, and partnership. A portion of the payment may be made to an organization described in IRC 170(c) provided that there is at least one person not an organization described in IRC 170(c). See Reg. 1.664-3(a)(3)(i).
- d. Period of Payment & Legal Life of Unitrusts - The duration of the payments depends upon who is the beneficiary. If the beneficiary is an individual, he or she is entitled to receive the payments for the duration of his or her life or a fixed period of years. If the beneficiary is a person that is not an individual (i.e. corporation, partnership, etc.), it is entitled to receive the payments only for a fixed period of years that cannot exceed 20 years. See Reg. 1.664-3(a)(5)(i). An IRC 170(c) organization that is a beneficiary may receive the payments for a fixed period of years or for the life of an

individual. Id. Where there are multiple beneficiaries, the payments cease when the life of the last beneficiary expires or the fixed period of years for the last beneficiary ends. A unitrust's legal life ends when the final payment is made to the last beneficiary and it legally dissolves.

- e. Payment & Amount - The unitrust must pay a fixed percentage of its net fair market value as valued annually to the beneficiary so designated in the trust instrument. The payment may be in the form of cash or other property. See Reg. 1.664-1(d)(5). The fixed percentage cannot be less than 5 percent. See IRC 664(d)(2)(A) and Reg. 1.664-3(a)(2)(i).
- f. Remaindermen - Once the life of the last beneficiary expires or the fixed period of years for the last beneficiary ends, the entire unitrust corpus must be irrevocably transferred to or for the use of one or more organizations described in IRC 170. See 664(d)(2)(C).
- g. Time of Payment & Filing Requirement - Payment to each beneficiary begins with the first year of the life of the unitrust. See Reg. 1.664-3(a)(5)(i). Reg. 1.664-3(a)(1) provides that the trust will not be deemed to have engaged in an act of self-dealing, to have unrelated debt-financed income, to have received an additional contribution, or to have failed to function exclusively as a charitable remainder trust merely because the unitrust payment is made after the close of tax year. For purposes of this rule, distribution must be made within a reasonable time after the close of the tax year. Reasonable time is satisfied where payment is made prior to the due date, including extensions, of Form 5227, Split-Interest Trust Information Return, which must be filed on or before April 15 following the close of the tax year.

## 5. Taxation of Payments Received by Beneficiaries - Tiers of Income



As mentioned above, a unitrust is exempt from income tax, and it must make annual payments to the beneficiaries. In consequence, these beneficiaries are taxed on those payments. The type of tax the beneficiaries have to pay on those payments is dependent upon the tax character of those payments when they were in the possession of the unitrust. The tax character is determined by reference to a four-tiered system outlined in IRC 664(b).

The four tiers are (1) ordinary income; (2) capital gains; (3) other income (such as tax-exempt income); and (4) trust corpus. After the trustee has collected all types of revenue (dividends, capital gains, tax exempt income, etc.) from the trust investment, deducted all expenses for that tax year, and determined the amount to be distributed, he or she makes the payments to the beneficiaries. The unitrust payments must be treated as having first been distributed from ordinary income. If the payments exceed the first tier, ordinary income, the excess comes second from capital gains, then third from other income, and finally from trust corpus. Current and previously undistributed income of each tier must first be exhausted in the above outlined order before income earned in the next tier is deemed distributed. The following example illustrates this four-tiered system:

**Example:** The net fair market value of the unitrust assets on the valuation date at the end of Year 1 is \$110,000. During year 1, the unitrust received \$5,000 in dividends, \$4,000 in capital gains, \$1,000 in tax exempt interest. The fixed percentage payout is 7 percent, and the payment to Jane Doe, the sole beneficiary, is \$7,700. Under the four tiered system, the \$7,700 payment Jane Doe received is treated as distributed first from dividend (ordinary income), then capital gains. In Jane Doe's tax return for Year 1, she lists the \$7,700 as follows: \$5,000 in ordinary income and \$2,700 in capital gains income. The net fair market value of the unitrust assets at the end of Year 2 is also \$110,000, and a payment of \$7,700 is made to Jane Doe. During Year 2, the unitrust receives \$5,000 in dividends, \$0 in capital gain, and \$2,000 in tax exempt interest. The \$7,700 is reported in Jane Doe's tax return as follows: \$5,000 in ordinary income, \$1,300 in capital gain (only \$2,700 of the \$4,000 capital gain was paid out in Year 1), and \$1,400 in tax exempt interest.

6. Notice 94-78, 1994-32 I.R.B. 15 - A Questionable Scheme: Accelerated Unitrusts

The Service, in Notice 94-78, states that charitable remainder unitrusts are

being used as vehicles to avoid a substantial portion of the tax on the gain of appreciated assets. The scheme to accomplish this goal is as follows:

Illustration: On the first day of year 1 a unitrust is created by Jane Smith who then donates stocks to that unitrust. The stocks are the sole assets of the unitrust. The stocks' net fair market value at the date of transfer is \$1 million with a zero basis, and the stocks do not pay dividends. The trust instrument provides that a) John Doe is the trustee; b) Jane Smith is to be the sole beneficiary of the unitrust income; c) an annual payment is made for a fixed period of two years, and the unitrust legally terminates thereafter; d) the amount of the annual payment to the non-charitable beneficiary is fixed at 80 percent of the net fair market value of the unitrust assets as valued annually; and e) the remainder goes to an IRC 501(c)(3) organization.

At the end of year 1 the stocks are valued at \$1 million, and the trustee, as planned, does not make the annual payment to the beneficiary. On the second day of year 2, trustee sells the stock for \$1 million, and distributes 80 percent of the proceeds (\$800,000) before April 15, year 2, to the donor so as to satisfy the distribution requirement for the first year. At the end of year 2, the trustee distributes \$160,000 (80 percent of the \$200,000 unitrust corpus) to the beneficiary and \$40,000 to the section 501(c)(3) organization, and thereafter the unitrust is dissolved. The beneficiary in her tax return does not list the \$800,000 as capital gain because she claims that the payment received for year 1 is a return of trust corpus. As to the \$160,000, she pays \$44,800 in capital gain taxes (\$160,000 x 28%).

[Notice 94-78 contains an example that illustrates this scheme. Although the facts in that example are different from the example herein, the strategy is basically the same.]

This scheme is based on the supposition that because no assets are distributed to the donor during year 1 (but are distributed before April 15, year 2), the unitrust amount for the first year is characterized as a distribution of trust corpus under IRC 664(b)(4) to the extent the distribution exceeds any ordinary or other income earned (or not earned, as in this illustration) by the trust during year 1. If the appreciated assets are sold or distributed in year 1, this scheme does not work because the \$800,000 would be treated as capital gain and be subject to a 28 percent tax. If all the assets are sold in year 1, the trust would realize a \$1,000,000

capital gain, and, under IRC 664(b)(2), the \$800,000 would also be capital gain income in the hands of the donor. If the payments were made to the donor in year 1, the net cash the donor received for the two years would be \$691,200 ( $\{ \$800,000 - \$224,000 \text{ [capital gain tax]} \} + \{ \$160,000 - \$44,800 \text{ [capital gain tax]} \}$ ) rather than \$915,200 (\$800,000 for year 1 + \$115,200 for year 2).

The Service states in Notice 94-78 that it disapproves of this usage of unitrusts, and may impose, depending upon the facts and circumstances, IRC 4941 taxes upon the creator/donor, trustee and/or other appropriate persons for such exploitation. Furthermore, the Service will challenge these transactions under one or more of the following legal doctrines: 1) substance vs. form doctrine; 2) assignment of income doctrine; 3) challenging trust's qualification as a charitable remainder unitrust under IRC 664.

#### A. Application of IRC 4941

The Service considers the transactions between the creator/donor and the unitrust outlined in the above illustration as acts of self-dealing, and the creator/donor and trustee may be subject to IRC 4941 taxes for such improper use of the unitrust's assets. As discussed in section 3 of this article, unitrusts are treated as if they were private foundations for certain purposes. One of these purposes is the self dealing rules under IRC 4941, and the creator/donor and trustee are disqualified persons for IRC 4941 purposes. The former is a disqualified person because she is the substantial contributor to and the creator of the unitrust. The latter is a disqualified person because he is a trustee or has authority or responsibility to make administrative decisions for the unitrust. In order for the above discussed scheme to work, there must be planning, coordination, and cooperation between the creator/donor and trustee. Thus, the creator/donor's and trustee's knowledge of or willingness to participate in this scheme would be hard to dispute.

The critical issue is whether the timing of the sale and in the distribution of the assets constitute acts of self-dealing; that is, whether the unitrust assets are used for the benefit of a disqualified person. As described in the above illustration, sales of the unitrust assets and payment of the unitrust amount to the creator/donor, Ms. Jane Smith, for year 1 must be delayed by the trustee until year 2, and any action taken to make the payment must likewise be delayed until early year 2. The purpose of this delay and, in fact, the entire scheme is to benefit the creator/donor (*i.e.* substantially reducing Ms. Smith's capital gain taxes). Such use constitutes the use of the unitrust assets for the benefit of the creator/donor, the

disqualified person. See e.g. Rev. Rul. 74-600, 1974-2 C.B. 385 (states that the placing of paintings owned by a private foundation in the residence of a substantial contributor, a disqualified person, constitutes an act of self-dealing).

In the illustration, Ms. Smith, the disqualified person, did not take physical possession of the unitrust property and use it for her own benefit. The self dealing act was in preventing the property from being used to benefit both the charitable and the non-charitable interests until the property was sold. The timing of the sale was to seek the maximum financial benefit for the disqualified person. Although Ms. Smith, the disqualified person, was also the income beneficiary of the property and presumably did not mind the diminution of her income interest, the charitable remainderman's interests also suffered. For example, had the property been sold on day one, the proceeds might have been invested in such a way as to increase the value of the remainder interest. Because the trustee was not free to benefit both of the interests that he was obligated to serve, the self dealing was the functional equivalent of the use of the property of a disqualified person. Hence, IRC 4941 taxes may be imposed upon Ms. Smith and/or Mr. Doe, the trustee.

Even if the property transferred to the unitrust consisted of real property, the amount involved for IRC 4941 purposes should be determined using a fair interest rate for use of the money. This is because the disqualified person did not take possession of the property. Delaying the sale to benefit the disqualified person caused the trust to forgo interest or other earnings that it might have had on an immediate sale.

#### B. Correction

Under IRC 4941(e)(1), the taxable period for an act of self dealing continues until the earliest of three events occurs: (1) the mailing of the notice of deficiency for the first level tax; (2) payment of the first level tax by the disqualified person; (3) correction of the act of self dealing is completed.

Correcting an act of self dealing terminates the taxable period (ending the accrual of the first level tax) and eliminates any potential liability for the second level tax only when all the necessary elements of correction have been completed. In the illustration, selling the property by the trustee in year 2 did not complete the correction. The disqualified persons, Ms. Smith and the trustee, would still need to make the unitrust whole. She and he would need to make up for the use of the proceeds that were foregone during the year the trust held the property to benefit the donor/disqualified person.

## C. Legal Doctrines - Challenging Treatment of the Gain

### (1) Substance vs. Form

In appropriate circumstances, the Service will not respect the form of the transaction as a sale by a tax-exempt charitable remainder trust, under the form vs. substance doctrine. Under this doctrine, a transaction is examined to determine whether there is economic substance as opposed to mere tax avoidance. That is, the transaction conducted is designed solely to avoid taxes and has no legitimate non-tax business reasons. See Gregory v. Helvering, 293 U.S. 465 (1935). As discussed in section 6 of this article, the purpose and design of the scheme is to shield a substantial portion of the payment received by the beneficiary from capital gains taxes. Furthermore, there is no indication that this scheme has any purpose or legitimate business reason other than to avoid capital gains taxes. Consequently, the substance of this scheme is tax avoidance, and the unitrust amount the beneficiary received for year 1 will not be treated as return of corpus, and the gain would be taxed. See Notice 94-78.

### (2) Assignment of Income

The Service may tax all the gain or the sale of trust assets to the donor, not to the trust, under the doctrine that one cannot assign his income to another. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945). In the above discussed scheme, the donor contributes appreciated assets to the unitrust, and the trustee has an obligation to execute the trust in accordance with its terms. The trustee must dispose of the appreciated assets in a taxable transaction in order to make distributions to the donor/beneficiary. The unitrust is thus used as a conduit to receive technical title of the appreciated assets while returning the proceeds to the donor/beneficiary once the appreciated assets are sold. Thus, in substance, the donor/beneficiary has given the trustee the proceeds of the sale of the appreciated property, which the trustee is required to distribute back to her. Consequently, gain realized upon the sale of the assets by the unitrust may be attributed to the donor/beneficiary as gross income under IRC 61(a)(3). See e.g. Estate of Applestein v. Commissioner, 90 T.C. 331 (1983). If the payment is characterized as trust corpus under this scheme, the tax on the proceeds of sale would be shifted away from the person receiving the economic benefits of the proceeds.

### (3) Not a Charitable Remainder Unitrust

Finally, the Service may tax the income earned from the sale of the appreciated assets to the trust because it is not exempt from federal income tax under IRC 664(c). That income is not exempt because the trust does not qualify as a charitable remainder unitrust under IRC 664. Reg. 1.664-1(a)(4) provides that a trust must function exclusively as a charitable remainder trust from the creation of the trust. As discussed in section 6, the unitrust has been created, structured and operated primarily to avoid the donor's capital gain taxes. This use is inconsistent with the requirement that the trust function exclusively as a charitable remainder trust as provided for in Reg. 1.664-1(a)(4), and, consequently, the trust is not a charitable remainder unitrust.

## 7. Identification and Examination of Unitrusts

The Service is in the process of identifying and examining accelerated unitrusts that have been used in the above discussed scheme. This scheme usually has the following key elements:

- a. The unitrust has a short period of legal life, usually two or three years;
- b. A very high fixed percentage, usually around 80 percent, is used to determine the payment to the non-charitable beneficiary/donor;
- c. The assets transferred to the unitrust are comprised of appreciated assets (such as stocks, land, etc.);
- d. The assets usually produce little or no ordinary income;
- e. Payment to the beneficiary for the first year is not made during that first year of the unitrust's legal life;
- f. The assets are sold for cash at the beginning of the second year of the unitrust's legal life;
- g. Payment to the beneficiary for the first year is made in the second year but before the April 15 deadline for filing Form 5227, Split-Interest Trust Information Return.

These elements can be identified by reviewing certain key information contained in a unitrust's Form 5227, Split-Interest Trust Information Return. The key information in the Form 5227 is as follows:

- a. Section B - Type of Entity: This scheme can be utilized only by charitable remainder unitrusts (Box(3)).
- b. Section D - Date the Trust was Created: This scheme occurs in first year of the trust (consequently, the Form 5227 is needed for the first year). Furthermore, this scheme only works if trust is created in beginning of year 1, otherwise, unitrust payment is prorated.
- c. Part I - The information contained herein indicates whether ordinary income or capital gains were earned. Under this scheme, little or no income and no capital gains will be earned.
- d. Part III - This section identifies the recipient of the unitrust payment, and the amount and the character of that payment. Look for large payment in first year that is listed as corpus in column (e) or as nontaxable income in column (d).
- e. Part IV - This section identifies the nature of the assets, whether they are cash, land, stocks, etc.
- f. Part V-B 51a - Unitrust Fixed Percentage to be Paid to the Recipients - This section identifies the percentage of the net fair market value assets that is used to determine the amount of the payment to the recipient. Look for a very high percentage.
- g. Part V-B - Total accrued distribution deficiencies from previous years - This section indicates whether there were payments made to the recipient in the previous year.

A Form 5227 has been reproduced in Appendix I, and Notice 94-78 has been reproduced in Appendix II.

## 8. Conclusion

In the tax year 1994, approximately 53,303 Forms 5227 were filed by charitable split-interest trusts. Thus, there is immense potential that many charitable remainder unitrusts are being utilized as devices to avoid capital gain taxes. After identifying and examining such unitrusts, exempt organizations examiners should use the above discussed remedies -- IRC 4941 and/or taxation of the gain -- to negate the result of this scheme. In determining whether IRC 4941 be used to penalize the appropriate participants in this scheme, exempt organizations examiners should consider all the facts and circumstances of the particular case. In determining whether the gain should be taxed under the legal doctrines that were discussed, they should also consider all the facts and circumstances of the particular case.